THE GLOBAL FINANCIAL CRISIS AND ITS IMPLICATIONS ON THE ROMANIAN BANKING SYSTEM

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1.Introduction

National Bureau of Economic Research of the United States defines crisis as "a major reduction in economic activity for several months reflected in the decrease of GDP, decline of individuals' income, reduction of the level of employment, decline of industrial production and consumption ".[3]

Although few are those who do not accept that this last global financial crisis is almost unprecedented, if we refer to the scale that it reached in time, it was found that almost every decade has brought an economic or financial crisis in some form or another.

Originally called "credit crisis" by the specialists, the financial crisis from 2007 - 2009, practically began in July 2007 with the loss of investors' confidence in the financial assets based on portfolios of mortgages securitized (asset backed securities ") issued on the U.S. market. The immediate effect was the emergence of a major liquidity crisis followed by a fairly significant infusion of cash into the system by the Federal Reserve and European Central Bank.

Most vulnerable to this crisis were the financial institutions directly involved in operations of securitization or in mortgage lending operations. These institutions were affected by the immediate crisis' effects such as bankruptcies of these institutions. The first alarm signal was given by the bankruptcy of New Century Financial, company specialized in providing sub prime credits, in April 2007. The year that followed was a year of bankruptcies landslide, an year in which many financial companies were withdrawn from trading on stock markets, being then taken partly or wholly by other banks or groups of banks. Lehman Brothers is included among the major financial institutions declared bankrupt and Merrill Lynch among those taken by other financial institutions.

In the global economy this crisis brought with it a loss of confidence in the financial system which has repercussions such as severe loss of liquidity, increased interest rates and the rising cost of internal and external funding.

It is possible the sharing of the current financial crisis' effect in several categories, but in this article we are referring mainly to direct effects on financial institutions: landslide bankruptcies, restructuring of companies and financial institutions, mergers and takeovers, direct financial support with major funding from governments. Our attention will be focused on the banking system from Romania.

Through this study we are trying to offer some views on how the banks and, not only them, should react to the global economic crisis. The need to regain the trust of the population is a solution more

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and more mentioned and that has to be emphasized.

2.The implications of the crisis on the Romanian banking system

Until the first half of 2007, the banking autochthon system was crossing a transition period, from being an emerging market to the stage of a mature one, but also being one of the most dynamic banking sectors worldwide. Although it has presented high rates of growth in recent years, the domestic banking industry is one of the operational sectors in Europe with the lowest level of banking. The main features of the domestic banking system from that period were: increasing competition (particularly in the segment of credit), expanding banking network, a high level of innovation of specific products, customer retention, implementation of Community standards and regulations - Basel II.

The increase of financial crisis in 2008 helped to bring the recession in developed countries and the reduction of acceleration in the economies of emerging countries. Moreover, the degree of vulnerability in emerging countries has increased through their dependence of external financing.

Mutual potentiation of negative developments in financial markets and the real economy determinates a volatile environment, stressing the difficulties of forecasting the magnitude of the impact on short and medium term of the global crisis on macroeconomic developments in our country. Romanian banking sector is very affected, there are made changes of interest rate of monetary policy, of interest rates charged on loans and deposits, while the banks' bad debts are increasing.

Overall, the crisis led to a loss of confidence in the banking system, and it s priority, now, is to regain the trust of bank's customers.

A very important step in this direction is related to the transparency of current activity, but also in terms of financial results that they obtained. Transposed in the law this requirement involves among others the mention of all interest, commissions, fees or any other costs in the credit contract, the ban to increase commissions and other costs specified in the contract and that the variation of the interest rate must be independent of the creditor's will and must be reported to the fluctuations of verifiable benchmarks.

National Bank of Romania is not in the position to reduce the rate of monetary policy that is still much lower compared with the rates charged on the market but may reduce the minimum reserves to such an extent as to be gradually injecting liquidity into the banking system. In terms of the depreciation of our currency, accompanied by high interest rates, in the near future, retail loans are at risk, especially those intended for consumption.

On the banking market from Romania during last autumn it was seen a change concerning the products which were promoted by the credit institutions. Thus, till the summer of 2008 we witnessed a fierce promotion of loans in general and of those of refinancing, in particular, starting from the autumn of 2008 the banks replaced their offers concerning credits with those created to attract deposits. This change in strategy is because local banks have not received funding from their "mothers", who are faced with a lack of liquidity on international markets, and the excess of the national currency on the local monetary market has disappeared.

Now we are in a situation characterized by the slowing of credit activity in the conditions in which local banks have granted loans well above the level of attracted resources. So for 1 euro attracted resource the local banks have granted loans of 1.3 euro, the difference being funded from abroad, and today this gap should be covered because the local credit institutions no longer manage to attract sufficient resources from abroad. By this it is justified the banks' orientation to attract resources from the domestic market. In fact, currently we are witnessing a tough competition between banking institutions, regardless of their size, to attract deposits.

More and more bank customers put themselves the following question: How the banks explain their rising costs? These costs are justified by the expenses that banks have to obtain resources, and not only, costs that are on an upward slope on the background of increasing country risk. What happened? The reference benchmark for credits in national currency (ROBOR) reached high values in autumn of last year resulting in increasing costs of loans in lei and even if the reference benchmark for credits in euro (EURIBOR) has diminished, the risk premium for Romania increased significantly, which led to high costs of loans in foreign currency. The depreciation of the currency is another factor that has negative repercussions on the cost of loans.

The year2008 brought with it increases of the nominal interest rates of both retail credits and credit dedicated to companies. Some banks have even decided to increase interest rates for loans in balance which had a major effect on the confidence that people, in general, and customers of banks, in particular, have in the banking system. The positive aspect was that such increases determined the rising of the interest rates for paid for deposits that reached and even exceeded 12% for those in national currency, beyond the 7% inflation.

Through the joint statement signed in Vienna by representatives of nine major banking groups which concert about 70% of the market, are conjured as major commitments the following: business continuity, maintaining the strong financial performance of Romanian subsidiaries and the fact that capital injections will be made when needed. Referring to maintaining the exposure toward Romania, banks that signed the agreement accepted the fact that is in their common interest "that all institutions concerned to undertake commitments".

In the context in which the National Bank of Romania releases some of the required reserves, the banking system will face the danger related to the possibility of withdrawing foreign currency from the market, when actually the National Bank should avoid imposing restrictions on currency flows in accordance with Community law and the assumption of our country for total liberalization of the capital.

This joint declaration is a white ball for the banking system in Romania as well as for external perceptions regarding the situation of Romania in terms of signing the loan agreement of nearly 20 billion from the IMF.

Already we can find on the market that the external financing agreement, signed with major international institutions (IMF, EC, EBRD, WB), has a direct effect on the credit market for individuals, as was anticipated the interest rates charged began to decline . An example is found in Transylvania Bank that has reduced interest rates of credits in lei for retail clients with one-two percentage points, reaching levels of 15% -15.5% per year.

Although bankers are starting to reduce credit interest the customers have now other obstacles. For example, as regards real estate loans prospects clients of banks face a more strict and conservative evaluation of the buildings. Moreover, there are cases in which bankers require that the collateral to be twice the amount of the loan so the customer must pay 50% of the property it wishes to acquire, knowing that last year the collateral needed to represent only 120% of the amount borrowed.

In this context, we consider it appropriate to do a thorough analysis of the rates of interest charged on the market in Romania.

2.1 Analysis of interest rate of monetary policy

In the present context the central bank initiated an upward trend for the interest rate of monetary policy; its level was increased in October 2007 and January 2008 with 0.5 percentage points, reaching the value of 8.0%. The firm reaction of the central bank also had as an excuse the boost of inflationary risks, especially those induced by the prospect of continued growth of wages, insufficient sustained by increases in productivity, and increased expenditure of the budget during election. In addition, it may be indicated a potential rise of foresights for inflation for companies and individuals in the event of extension of deviation for annual rate of inflation from target, over the first part of 2008. The first increase of 0.5 percentage points on interest rate of monetary policy (up to 7.5%) was caused by a deterioration of the pattern's projected annual rate of inflation (mainly due to the strong growth of prices of food and sustained correction of the leu / euro exchange rate in the context of turmoil produced on international financial markets). The second decision to increase by 0.5 percentage point the interest rate of monetary policy was influenced by the extension of the inflationary nature of supply shocks (mainly the growth of food prices) with the emergence of indicators for demand pressure and from the need to counteract the tendency of weakening the inclinations towards saving.

By increasing the interest rate of monetary policy, central bank sought to temperate the populations request for loans, knowing that their balance is on an upward trend (in the fourth quarter of 2007 amounted to 62.1% over previous quarter - 58, 8%).

The growth registered by the rate of monetary policy and the stint of the credit institutions' call to the deposit facility have had the effect of a gradual increase in average efficiency of credit institutions' investments to NBR. However, it became apparent a change in yields of interbank deposits, revealed by the increasingly strong tendency to stabilize on a level in the proximity of interest rate of the monetary policy.

In February and March 2008, the NBR has made two new increases in the rate of monetary policy by 1% and 0.5%, its level reaching 9.5%. This time the reasons were justified by the risk of triggering a dangerous wage-inflation spiral (due to the extension or worsening decorrelation wage-productivity) and the potential production of side effects of inflationary supply shocks, a relaxation of fiscal policy during the election period, but also by the increased exchange rate volatility and uncertainties regarding short-term prospects, based on the persistence of tensions in the economic international environment.

In the second quarter of 2008, the central bank has made two further increases of interest rate of monetary policy (in May and June by 0.25 percentage points), that reached the level of 10%. To the initial causes of increasing the interest rate can be added the worsening of short-term inflation prospects, the potential continuation of the national currency's depreciation and the increase of international oil prices.

At the seventh consecutive increase (in July), the central bank increased by another 0.25 percentage point the interest rate of monetary policy, further maintaining it at 10.25% per year. NBR's decision was justified by the continuing increase in wages, in excess, compared to that of labour productivity, lack of coordination of fiscal policy and of income policy with monetary policy, the resumption of the national currency depreciation as a result of shocks generated in international markets, the deterioration of expectations of companies concerning the inflation and adjustments made to administered prices compared with those anticipated at the time of projection.

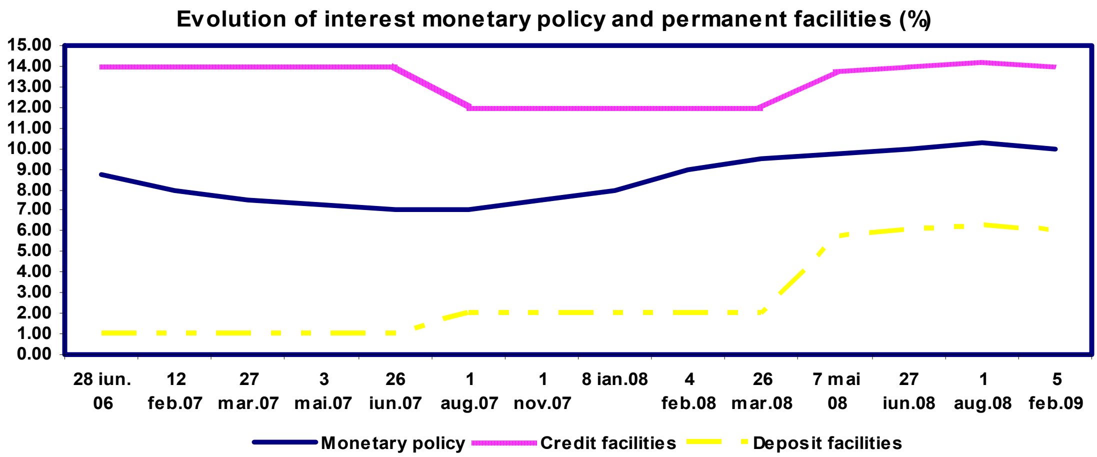
In September 2008 the interest rate of monetary policy is not amended, the main argument being the increased uncertainty about economic and financial developments in the short term, due to amplified proportions of the international financial crisis.

Starting in October 2008 till January 2009, the central bank kept interest rate of monetary policy at 10.25%, but reduced the reserve requirements applicable for liabilities in lei from 20% to 18%, starting since 24 November 2008. Reserve rate applicable to liabilities in foreign currency remained at 40%. During the same period, the trend of depreciation of national currency and the volatility of its exchange rate has been emphasized in the context of an intensified international financial crisis and increased investors' abhorrence of risk.

And the inevitable happens: in February 2009 it is reduced the interest rate of monetary policy at 10% per year, this being the only chance to continue funding. Keeping monetary policy interest rate at 10.25% per year would have mean the existence of uncertainties related to the administrated prices, while concerning them it began the talk about increases.

In late March 2009, the National Bank of Romania decided to maintain interest rate of monetary policy at 10% per year. Another measure taken was to reduce to zero the rate of minimum reserves for liabilities in foreign currency with residual maturity of more than two years, compared to 40% at present time, with implementation since 24 May – 23 June 2009. It was also decided the active use of market operations to adequate manage the liquidity in the banking system and the maintaining of the current rate of reserve requirements for liabilities in national currency and of those applicable to liabilities in foreign currency. Concluding the idea presented above, in Chart Number 1 we highlighted the trend of the rate of monetary policy from June 2006 to February 2009.

Chart No.1



Source: Monthly Bulletin of the National Bank of Romania

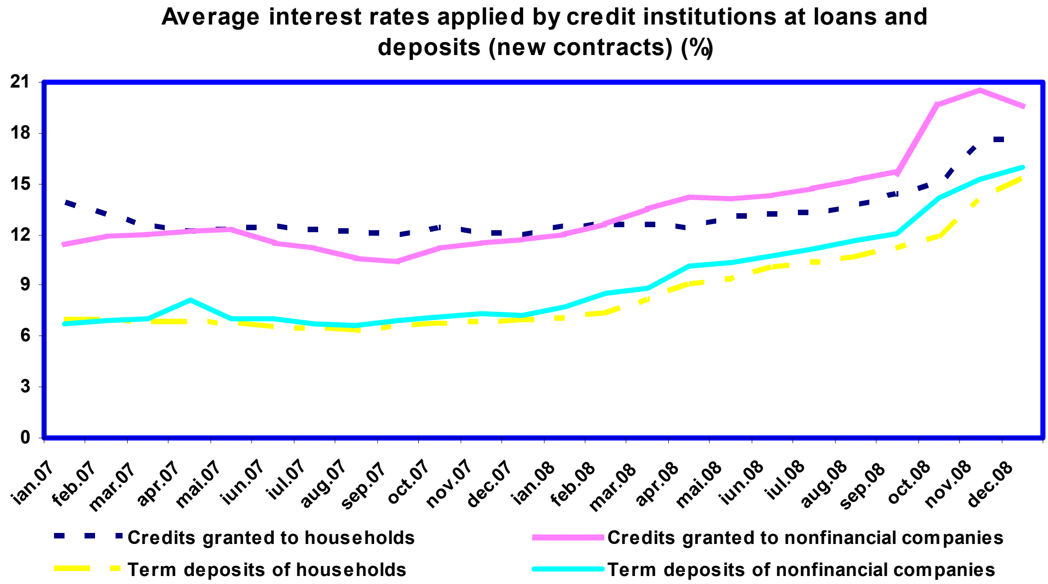
2.2 Analysis of the interest rates applied to loans and deposits

The growth of the rate of monetary policy by the end of October 2007 and the increase of stock interchange ROBID and ROBOR have printed an upward trend of average interest rates for new deposits of both retail clients and companies. Thus, the average interest rate on deposits of population increased from 6.37% (in August 2007) to 15.27% (in December 2008), for companies the increase was from 9.35% to 16. 01%.

In the case of new credits granted in this period, the evolutions have been uneven. Thus, in December 2008, the average interest rate on loans was 17.64% for retail clients (+5.48 percentage points compared to August 2007), and 19.51% for companies (+8, 97 percentage points).

This evolution was primarily the result of maintaining strong competition in the banking system, which has led credit institutions to launch new products with advertisements (e.g. consumer loans with fixed interest rate for a certain period). Issues mentioned above are presented in the graph number 2.

Chart No.2



Source: Monthly Bulletin of the National Bank of Romania

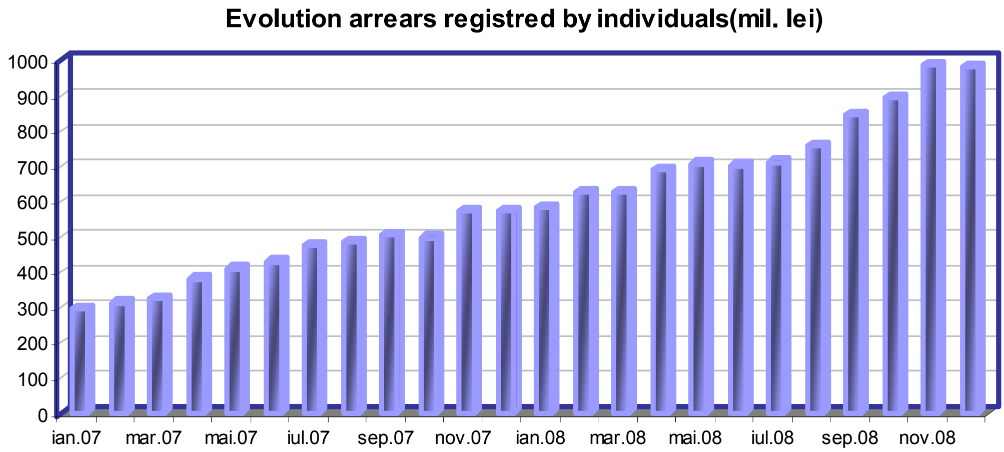
2.3 The analyze of the bad debts' evolution

According to a study, 32% of households in Romania pay monthly credits worth 30% of their income. The significant depreciation of the currency, the excessive growth of interest rates for credits, inflation, unemployment are some arguments that have had an impact on population income and on its possibilities regarding repayment of loans and interests.

There are an increasing number of individuals experiencing significant delays in reimbursement rates so the bad debts of population increased in December 2008, with 71% versus the same period of the last year.

Most bad debts (of population and companies) are loans in the national currency, totaling over 400 million euros. A conspicuous place in the list is occupied by the persons from Bucharest, that have total bad debts of 170 million euros (one of the reasons is that they have the biggest value of loans from banks - over 18 billion euros). The evolution of the bad debts of individuals recorded during January 2007 - December 2008 is caught it in the chart below.

Chart No.3



Source: Monthly Bulletin of the National Bank of Romania

2.4 The implications of the crisis on state securities

Financial crisis had a positive impact in terms of state securities. The market has shown a special interest for financial instruments with fixed income which, although offering low yields, do not present a high risk.

If in the last quarter of 2007 were made only 3 issues of government bonds on the primary market (from the 11 proposed) worth 503 million lei - through these programs were put into circulation treasury certificates (due on 6 months) and state bonds (due on 10 years), giving average yields of 7.85% and 7.36%, in the last quarter of 2008, the volume of securities issued reached approximately 6.711 million lei - being offered yields above 10%.

Also, to accommodate investors' preference for short-term investments, the Ministry of Public Finance reintroduced (after a pause of approximately 3 years) in circulation treasury certificates maturing in 3 months.

Investors on long and medium term are interested of maturities between 5 and 10 years, taking account of good returns offered by government bonds today.

The global relaxation of credit crisis can enable the possibility for a new start on the increased volume of the issues of government bonds.

3. Conclusions

Any crisis leads to the rethink of the facts therefore the current crisis is subject to these rules. Also, the concepts of liquidity and risk, and their acceptance as such is a matter that will influence how the banks operate and are supervised by the institutions concerned. Probably the accent will be focused on banks' ability to distribute all the elements of risk.

From our point of view, in what concerns the year 2009 and the next three to five years, the banking landscape will be transformed completely. We already have fewer active players on the market able to provide banking products and services for different business areas.

To exit the crisis is also needed at the level of the banking system, global cooperation that will entail a major change in the industry. With so many players in this market, inevitably will be imposed harsh measures to exit the current crisis so that, despite uncertainty about what 2009 will bring, many banking companies from Romania and not only, will have to make fundamental changes.

The transformations of which the banking system needs to exit the crisis are only the beginning of this road. By making changes, bankers will be able to define their success not through the amount of revenue recorded but through the quality of these earnings. It will not be easy, but it is necessary to rebuild a tradition of trust and a legal framework sustainable for long term.

Regarding the loan received by our country from the IMF, we find that it contains clauses that refer to the Romanian banking system such as to grant increased powers for the NBR and the high degree of solvency for commercial banks, solvency to be maintained at over 10%, although the minimum required by the Basel Agreement is only 8%. Another requirement of the IMF on the banking segment is for the NBR to obtain greater powers to initiate insolvency proceedings and liquidation for commercial banks. Also adds that the National Bank shall have the right to determine when a credit institution can not refund deposits and the payment for them will fall within the competence of the Guarantee Fund of Deposits, all this without the need of Central Bank to wait for the Courts decision on insolvency.

The agreement has a direct effect on the credit' market for individuals by reducing the cost of external financing, resulting in lower credit costs. For example, Romanian Bank for Development aims to reduce interest rates for loans at 10% -12% per year. In the meantime, Transylvania Bank has operated the cutting down by 1-2 percentage points (while maintaining the level of 15% - 15.5%), and Raiffeisen Bank cutted down the costs of loans by 3-4 percentage points.

It is obvious that we should expect a different regulatory environment on all financial markets that will probably bring contradictory laws in different states of the world. In this context, banks should be prepared and have the flexibility to consolidate the measures imposed under their global strategy.

Establishing what is risky and what isn't risky is the heart of developing a framework regulation concerning risk and risk management. The current risk management systems have gained too little in terms of the flow of derivates that produced this magnitude of sub prime crisis. New systems of risk management must be developed and, credit institutions should reorient their policy on acceptable risks.

It is imperative to use every lever available to try to solve the current problems but, however, banks must not lose sight of the need for innovation and development of all aspects of banking activity. In 2009, this goal will be reached by the need of the credit institutions to improve efficiency and productivity. Operations must be streamlined, transactions' cost reduced as possible and the products and banking services rethought.

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